Solution 12.1

a) An investment property is held for rental income or capital appreciation whereas an owner-occupied property is used by the entity in the production of goods or services or for administration purposes.

b) A comparison of the models allowed in terms of IAS 40 for investment properties with the models allowed in terms of IAS 16 for property, plant and equipment is as follows:
- Property, plant and equipment may be measured under the cost model or revaluation model.
- Investment properties may be measured under the cost model or fair value model.
- The cost model is the same in both cases.
- The revaluation model requires that increases/ decreases above HCA be recognised as other comprehensive income (revaluation surplus: equity) whereas increases and decreases below HCA are to be recognised in profit or loss
- The fair value model requires that all increases/ decreases, irrespective of the HCA be recognised directly in profit or loss.

HCA: historical carrying amount (depreciated historic cost).

c) The four scenarios under which a transfer may be made into investment property or from investment property from/ to another asset are as follows:
- From investment property to:
  - i) Inventories: when development for future sale begins
  - ii) Property, plant and equipment: when owner-occupation begins
- From property, plant and equipment to:
  - iii) Investment property: when owners move out
- From inventories to:
  - iv) Investment property: when operating lease begins.

Solution 12.2

Introduction

The farm is used:

- by Splurge Limited for milking and grazing (stand-alone shed and 40 hectares of land); and
- to earn rentals (from the 160 hectares and four sheds).

According to IAS 40 if a building is owner occupied building and can be sold separately (which it can because it has separate title deeds) it must be disclosed as property, plant and equipment in accordance with IAS 16.

Owner-occupied

This means that the owner-occupied stand-alone shed together with the related 40 hectares must be measured using either:
- the cost model; or
- revaluation model.

Whichever model is used, the property will be initially measured at cost. Assuming that all the sheds are similar, the owner-occupied shed and 40 hectares should be recorded at C400 000 (C2 000 000 x 40 / 200 hectares).

Cost model:

The cost model entails measuring the asset at cost less accumulated depreciation and impairment losses.

Revaluation model:

The revaluation model entails measuring the asset at fair value less subsequent accumulated depreciation and impairment losses. If the revaluation model is adopted and a revaluation to fair value results in an increase in carrying amount above its historical carrying amount, this increase must be recognised in other comprehensive income and accumulated in equity (not profit and loss).

Depreciation under both models:

Depreciation must be provided over the useful life of the property to its estimated residual value. The most appropriate methods of depreciation would be either the straight-line or reducing balance method. If at any stage the residual value is greater than the property's carrying amount, depreciation must cease. Depreciation should begin when the property is available for use and should not cease when temporarily idle. Land would not be depreciated as it has an indefinite useful life.

Not owner-occupied

Since the 160 hectares and remaining four sheds are leased out to earn rentals, this property is recognised and measured as investment property in terms of IAS 40. Investment properties may be measured using either the:
- cost model (IAS 16) or
- fair value model (IAS 40 prefers this method).

Solution 12.2 continued …

Whichever model is used, the investment property will be initially measured at cost. Assuming that all the sheds are similar, the four remaining sheds and 160 hectares should be recorded at C1 600 000 (C2 000 000 x 160 / 200 hectares).

Cost model:

If Splurge Limited uses the cost model the farm sheds and 160 hectares are carried at cost less subsequent accumulated depreciation and impairment losses (i.e. in terms of IAS 16). It may not be re-valued.

Fair value model:

If Splurge Limited uses the fair value model, the entity must report the farm (the four sheds and the 160 hectares) at fair value. Any increase or decrease in fair value from the end of one reporting period to the next must be recognised as an income or expense in the year of the change.

If Splurge Limited cannot ascertain the fair value (where fair value is the market price between knowledgeable, willing parties in an arms length transaction) of the investment property it must apply the following rules:

- If the fair value could not be ascertained on the date of purchase, the investment property must be carried at depreciated historic cost (cost model).

- If the fair value could not be ascertained at the end of a subsequent reporting period, the investment property must be carried at the last available fair value.

Solution 12.3

a) Journals

		Debit	Credit
1 January 20X5			
Quetta building: cost (PPE)		1 200 000	
Bank/ liability			1 200 000
Purchase of Quetta building (owner-occupied)			
Karachi building: cost (Investment prop)		500 000	
Bank/ liability			500 000
Purchase of Karachi building (leased to a tenant)			
30 June 20X5			
Depreciation	*(1 200 000 / 10 x 6 / 12 months)*	60 000	
Quetta building: accum. depr. and impairment losses (PPE)			60 000
Depreciation of building (PPE) to date of destruction			
Impairment	*(1 200 000 - 60 000)*	1 140 000	
Quetta building: accum. depr. and impairment losses (PPE)			1 140 000
Write-off after earthquake			
Quetta building: accum. depr. and impairment losses (PPE)		1 200 000	
Quetta building: cost (PPE)			1 200 000
Derecognition of Quetta building after the earthquake destroyed it			
Karachi building: cost (Investment prop)	*(950 000 – 500 000)*	450 000	
Fair value adjustment to investment property (income)			450 000
Revaluation of investment property prior to change in use			
Karachi building: cost (PPE)		950 000	
Karachi building (Investment property)			950 000
Transfer from investment property to property, plant and equipment			
31 December 20X5			
Depreciation	*(950 000 / 9.5 x 6 / 12 months)*	50 000	
Karachi building: accumulated depreciation and impairment losses			50 000
Depreciation to year-end Karachi building (PPE)			

b)

Investment property is defined as land or buildings (or both) that are held to earn rentals or for capital appreciation. Investment properties do not include land or buildings that are:

- held for use in production or supply of goods or services;
- held for resale as trading stock;
- in the process of being constructed by the entity itself; or
- held for administrative purposes.

Owner-occupied property is defined as land or buildings held for use in the supply of goods and services or for administration use, which could include:

- property being developed;
- administration buildings;
- employees housing; and
- factory buildings.

Solution 12.3 continued …

c)

Fair value is the value that the property could be sold for in an arms length transaction between knowledgeable, willing parties, without deducting transaction costs, but taking into account the:
- actual and potential uses;
- the market conditions at the end of the reporting period;
- rental incomes; and
- future market conditions.

IAS 40 recommends, but does not require, that this fair value be determined by an independent and suitably qualified valuator.

Solution 12.4

a) Office block

		Debit	Credit
30 June 20X5			
Depreciation	*(1 000 000 – 0) / 10 years x 6/12*	50 000	
Office block: accumulated depreciation (PPE)			50 000
Depreciation on owner-occupied office block to date of change in use			
Office block: accum. depr (PPE)	*O/bal (1 000 000 – 0)/ 10 years + 20X5 depr: 50 000 (above)*	150 000	
Office block: cost (PPE)	*Given*		1 000 000
Office block (investment property)		850 000	
Transfer from property, plant and equipment to investment property on date of change in use			
31 December 20X5			
Office block (investment property)	*(1 500 000 – 850 000)*	650 000	
Fair value adjustment to investment property (income)			650 000
Investment property re-measured to fair value at year-end			

b) Leasing to a subsidiary within a group

Since Chattels Chief Limited does not occupy the property but holds it to earn rental income, it should be accounted for as investment property in the books of Chattels Chief Limited.

Since, however, the group of companies owns a property that is occupied by a subsidiary within the group, it is classified as owner-occupied from the group perspective and should therefore be measured according to the principles laid out in IAS 16: *Property, Plant and Equipment* when preparing the books for the group.

Solution 12.5

SNAKE LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X5 (EXTRACTS)

		20X5 C
3 Profit before tax		
Profit before tax is stated after:		
Income:		
Income from investment properties:		
- Fair value adjustments: investment properties (W1)	Note 27	2 000 000
- Rental income earned from investment properties		2 000 000
Expenses:		
Investment property expenses		1 000 000
- Properties earning rentals (rates)		400 000
- Depreciation on investment property *(Balochistan): see calculation (a)*		475 000
- Depreciation on property, plant and equipment *(Karachi and Lahore)*		

(a)	*Balochistan building*	*(5 000 000 – 1 000 000) / 10 years x 1 year*	400 000
(b)	*New Karachi head office*	*(4 000 000 - 500 000) / 5 x 3 / 12*	175 000
	Old Lahore head office	*(4 000 000 - 0) / 10 x 9 / 12*	300 000
			475 000

27 Investment property

There is an active market for the investment property.

		20X5 C		
		Carried at cost	Carried at fair value	Total
Carrying amount: 1 January 20X5		3 800 000	3 000 000	6 800 000
• Cost	*Given*	5 000 000		
• Accumulated depreciation	*(5 000 – 1 000)/ 10 x 3*	1 200 000		
Transferred from inventory			1 000 000	
Transferred from property, plant and equipment as no longer owner occupied *[CA: 4 000K – (4 000K – 0)/ 10 x 2 years] [CA = FV]*			3 200 000	
Transferred to property, plant and equipment when it became owner occupied	*(the Karachi property: transferred out at its CA, which is its FV)*		(4 000 000)	
Depreciation	(*the Balochistan property*: *because the FV could not be ascertained, the Balochistan property is measured under cost model)*	(400 000)		

Fair value adjustment (W1)			2 000 000	
Carrying amount: 31 December 20X5	*(W2)*	3 400 000	5 200 000	8 600 000
• Cost		5 000 000		
• Accumulated depreciation		1 600 000		

Solution 12.5 continued …

Workings

W1: Fair value adjustment		**C**
Islamabad building	*1 500 000 – 1 000 000*	500 000
Karachi building	*4 000 000 – 3 000 000*	1 000 000
Lahore building	*3 700 000 – 3 200 000*	500 000
		2 000 000

W2: Carrying amount of investment properties measured at fair value		**C**
Islamabad building	*Given*	1 500 000
Lahore building	*Given*	3 700 000
		5 200 000

Summary of the situation for explanation purposes only:

Islamabad building:
- this was inventory
- this is now investment property
- measured under the fair value model.

Balochistan building:
- this is investment property
- that has to be measured under the cost model (despite the accounting policy for all other investment property being the fair value model) because the fair value is not ascertainable.

Karachi building:
- this started out as investment property (leased out) but then
- became property, plant and equipment (owner-occupied): change in use.

Lahore building:
- this started out as property, plant and equipment (owner-occupied) but then
- became investment property (leased out): change in use

Solution 12.6

a)

	Debit	Credit
1 January 20X4		
Investment property: cost *(300 000 + 20 000)*	320 000	
Bank		320 000
Purchase price plus conveyancer's fees (which are necessarily incurred in order to bring the building into use)		
31 July 20X4		
Maintenance expense	50 000	
Bank		50 000
Painting expensed (does not increase the future economic benefits embodied in the asset)		
1 October 20X4		
Investment property: cost *(200 000 + 30 000 + 50 000)*	280 000	
Bank		280 000
Capitalisation of the air-conditioning system		
31 December 20X4 *(320 000 / 10) + (280 000 / 111m x 3m)*		
Depreciation	39 568	
Investment property: accumulated depreciation		39 568
Depreciation of investment property – see note 1		
31 December 20X4		
Investment property *1 250 000 – 1 000 000*	250 000	
Fair value adjustment to investment property		250 000
*Fair value adjustment on **other** investment property – see note 2*		

Note 1: *although the air-conditioning system has a useful life of 10 years, it is integral to the building. This means that it must be depreciated over the remaining useful life of the building. At the time of installation, there were 9 years and 3 months left (9 x 12 months + 3m months = 111 months).*

Note 2: *This fair value adjustment relates to <u>other</u> investment property (<u>not</u> Tromp Towers). Please note that the question did not give you the fair value of Tromp Towers on 31 December 20X4. If the question had given you the fair value of Tromp Towers, however, you would have had to ignore it because IAS 40.53states that if a fair value was not reliably determinable on a continuing basis on initial acquisition and was therefore forced to use the cost model initially, then that property must always be held under the cost model (i.e. even if it subsequently becomes possible to determine the fair values, the fair value model may never be used for this property).*

Solution 12.6 continued …

b)

TROMP LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X4 (EXTRACTS)

25. Investment property

	20X4		
	Carried at Cost C	**Carried at fair value C**	**Total**
Balance: 1 January 20X4	0	1 000 000	1 000 0000
Cost/ fair value	0		
Accumulated depreciation	(0)		
Additions	320 000	0	
Improvements	280 000	0	
Fair value adjustments	0	250 000	
Depreciation	(39 568)	0	
Balance: 31 December 20X4	560 432	1 250 000	1 810 432
Cost/ fair value	600 000		
Accumulated depreciation	(39 568)		

Please note:

When originally purchased, the fair value of Tromp Towers could not be reliably determined. As a result, this investment property could only be accounted for using the cost model.

Tromp Limited is, however, allowed to adopt the fair value model for all its other investment properties (IAS 40.53).

At the end of the current year, the fair value of Tromp Towers became reliably determinable for the first time. Tromp Towers must, however, still be measured under the cost model until disposal despite its fair value being reliably determinable (IAS 40.53).

Solution 12.7

a)

		Debit	Credit
31 July 20X4			
Investment property: the Poplar		500 000	
Bank			500 000
Recording the acquisition of investment: the Poplar			
31 December 20X4			
Investment property: the Poplar	*600 000 – 500 000*	100 000	
Fair value adjustment to investment property (Income)			100 000
Fair value adjustment to investment property: the Poplar			
Tax expense	*W1*	7 500	
Deferred tax			7 500
Deferred tax adjustment relating to FV adj. on the Poplar			
31 December 20X5			
Investment property: the Poplar	*700 000 – 600 000*	100 000	
Fair value adjustment to investment property			100 000
Fair value adjustment to investment property: the Poplar			
Tax expense	*W1*	7 500	
Deferred tax			7 500
Deferred tax adjustment relating to FV adj. on the Poplar			
31 December 20X6			
Investment property: the Poplar	*750 000 – 700 000*	50 000	
Fair value adjustment to investment property			50 000
Fair value adjustment to investment property			
Tax expense	*W1*	7 500	
Deferred tax			7 500
Deferred tax adjustment relating to FV adj. on the Poplar			

Workings 1: Deferred tax calculation

	CA	TB	Difference	Permanent Difference	DT	
Balance: 1/1/20X4	0	0	0	0	0	
Purchase:31/7/20X4	500 000	500 000	0	0	0	
FVA/ W&T	100 000	(25 000)	125 000	100 000	(7 500)	Cr DT; Dr TE
Balance:31/12/20X4	600 000	475 000	125 000	100 000	(7 500)	Liability
FVA/ W&T	100 000	(25 000)	125 000	100 000	(7 500)	Cr DT; Dr TE
Balance:31/12/20X5	700 000	450 000	250 000	200 000	(15 000)	Liability
FVA/ W&T	50 000	(25 000)	75 000	50 000	(7 500)	Cr DT; Dr TE
Balance:31 /12/20X6	750 000	425 000	325 000	250 000	(22 500)	Liability

Solution 12.7 continued …

b)

2 January 20X5		**Debit**	**Credit**
Investment property: Palms		200 000	
Bank			200 000
Purchase of investment property: The Palms			
31 December 20X5			
Investment property: Palms	*(250 000 – 200 000)*	50 000	
Fair value adjustment to investment property			50 000
Fair value adjustment to investment property: The Palms			
Tax expense	*W1*	3 000	
Deferred tax			3 000
Deferred tax adjustment relating to FV adjustment The Palms			
31 December 20X6			
Investment property: Palms	*(400 000 – 250 000)*	150 000	
Fair value adjustment to investment property			150 000
Fair value adjustment to investment property			
Tax expense	*W1*	3 000	
Deferred tax			3 000
Deferred tax adjustment relating to FV adjustment The Palms			

W1: Deferred tax calculation

Investment property: intention to sell		**Carrying amount**	**Tax base**	**Difference**	**Permanent difference**	**Deferred taxation**	
Balance: 1 Jan 20X4		0	0	0		0	*Liability*
Purchase 2 Jan 20X5		200 000	200 000				
Movement	(3)	50 000	(10 000)	(60 000)	(50 000)	(3 000)	*Cr DT Dr TE*
Balance: 31 Dec 20X5	(1)	250 000	190 000	(60 000)	(50 000)	(3 000)	*Liability*
Movement	(3)	150 000	(10 000)	(160 000)	(150 000)	(3 000)	*Cr DT Dr TE*
Balance: 31 Dec 20X6	(1)	400 000	180 000	(220 000)	(200 000)	(6 000)	*Liability*

Solution 12.8

Letterhead

My contact details
Date of letter

Cool Limited's address
Attention: Financial Director's name

Dear Sir

Re: your request for clarification regarding the accounting for the office building

Your head office building was previously 100% owner-occupied. This meant that it was previously classified as property, plant and equipment (IAS 16).

Since 60% of this building is now leased out whilst 40% is owner-occupied, this property is now a joint-use property.

Had the two portions been separable (i.e. were it possible to sell the 60% separately from the remaining 40% or were it possible to lease this 60% separately from the 40% under a finance lease), it would have meant that each portion would have had to be classified separately (i.e. 60% classified as an investment property and 40% as property, plant and equipment).

However, since you have indicated that this property is not separable, IAS 40 requires that you establish whether the portion used as an investment property is the most significant portion or not.

Professional judgment is required in determining what constitutes a significant portion and your company will need to establish its own criteria such that this judgment can be applied consistently (these criteria would then need to be disclosed).

My opinion is that 60% should be considered a significant portion of the property, in which case the entire property would need to be classified as an investment property since the 60% was used as investment property. In the event that you believe that, for example, a minimum of 70% would need to be reached before classifying a portion as a *significant* portion, then the entire property would *remain* classified as property, plant and equipment since it must *only* be classified as investment property *if the significant portion is used as investment property*. The property is therefore classified as property, plant and equipment if the significant portion is used as property, plant and equipment or if there is no significant portion.

Assuming you agree with my suggestion that 60% is a significant portion, (i.e. that the property must now be reclassified as an investment property), then we are agreed that there has effectively been a change in use: from owner-occupied (*IAS 16: Property, plant and equipment*) to a property held to earn rental income (*IAS 40: Investment property*). The property must therefore be transferred from property, plant and equipment to investment property.

Before the transfer is journalised, the property must first be depreciated, revalued to fair value (given that your property was previously measured using the revaluation model) and then checked for impairment. All these measurement adjustments must be accounted for in terms of IAS 16 (IAS 40.61). Thereafter, the property is transferred to investment property and measured under the fair value model.

P.T.O.

Solution 12.8 continued …

Letter continued ….

I have taken the liberty of including the journals that you would need to process:

1 January 20X5	**Debit**	**Credit**
Office building: carrying amount (PPE)	600 000	
Bank/ liability		600 000
Purchase of head-office building(owner-occupied)		
30 June 20X5		
Depreciation expense *(600 000 – 0) / 10 x 6 / 12 months)*	30 000	
Office building: carrying amount (PPE)		30 000
Depreciation to date of change in use		
Office building: carrying amount (PPE)	230 000	
Revaluation surplus		230 000
Revaluation of head office to fair value on date of change in use		
[800 000 – (600 000 – 30 000)]		
Office building: fair value (Investment property)	800 000	
Office building: carrying amount (PPE)		800 000
Transfer head office building from PPE to IP on date of change in use		
Office building: fair value (Investment property)	20 000	
Fair value adjustment on investment property (income)		20 000
Measurement of investment property to fair value at year-end		

Please do not hesitate to contact me if you have any further queries.

Sincerely

_____

S Mart
Your IFRS consultant

Solution 12.9

It is apparent that the office park is being held for two separate purposes:

- To house the head office for administration purposes
- To earn operating lease rentals

As the head office building is used for administration purposes it would be classified as property, plant and equipment. It can be measured using the cost model or the revaluation model. If the cost model is used the building will be measured at cost and depreciated each year. If measured using the revaluation model the building must be revalued with sufficient regularity so that the carrying amount will not differ significantly from fair value. Any adjustment needed due to a revaluation will be recognised in other comprehensive income. The building will also be depreciated each year.

The other two stand-alone buildings will be classified as investment property. IAS 40 allows the cost model or the fair value model to be used. Under the fair value model, the fair value of the investment property is determined at reporting date and the property's carrying amount in the statement of financial position must reflect this fair value. The fair value adjustment is recorded in profit or loss.

IAS 40 prefers the fair value model on the basis that it gives more relevant information. The problem with using the fair value model is that IAS 40.31 explains that a voluntary change, back to cost model, would be highly unlikely given that the fair value model provides more relevant information. IAS 40.55 actually takes this further and actually disallows the change in model for an investment property that was measured under the fair value model.

The fact that a number of properties are held under operating leases might suggest that the fair value model should be used since this would then enable Uncertain Limited to bring these properties into the statement of financial position as investment properties in terms of IAS 40.6 (assuming that these properties would otherwise meet the definition of an investment property).

The CEO's assumption that the cost model will be cheaper to implement as the fair value will not be needed is incorrect. IAS 40.32 requires that the fair value be determined, whether it is for measurement purposes or just for disclosure purposes.

The CEO's assumption that the cost model might have the least impact on the financial statements is debatable because the impact depends on the economic situation in the property market. The fair value model may indeed have a greater effect on the financial statements than the cost model during periods in which the property market is experiencing dramatic fluctuations in fair values, which would now be brought into your profits. If on the other hand, the property market is stable, the cost model would have more impact via the standard depreciation charge versus a potentially negligible fair value adjustment.

Solution 12.10

a. The block of flats is a dual use (joint use) property. If the first three storeys can be sold or leased (in terms of a finance lease) separately from the top three storeys, then the first 3 storeys must be classified as property, plant and equipment and the top three storeys must be classified as investment property. If they cannot be separated in this way, then only if a significant portion is used as an investment property should the whole building be classified as investment property (i.e. if an insignificant portion is used as an investment property, then the whole building would be classified as property, plant and equipment). In order to classify the building one way or the other, Gary Limited must develop criteria as to what they consider a significant portion of the property (these criteria will then need to be disclosed). If the three storeys that are leased out under operating lease agreements is not considered to be a significant portion (IAS 40.10) of the building, the entire building must be classified as property, plant and equipment. The building will be measured using the cost or revaluation model and will be depreciated each year. If the property is classified as investment property, then there is a choice between the cost model and the revaluation model.

b. This is also a dual use (joint use) property. If the first three office rooms can be sold or leased (in terms of a finance lease) separately from the remaining seven rooms, then the first 3 rooms must be classified as property, plant and equipment and the other seven rooms must be classified as investment property. If this is not the case, since a significant portion is held to earn rentals (i.e. used as investment property), the entire property must be classified as investment property. The ancillary services provided are insignificant. Had these services been significant or had the rooms been occupied by employees of Gary Limited, the motel would have been classified as property, plant and equipment. If the three rooms could not be separated from the seven rooms as described above, the motel would be classified as an investment property. The motel would therefore be measured at fair value. Any fair value adjustments will be recorded in profit or loss.

c. Fairvalue Limited is a property dealer. The buildings that it owns would therefore have been classified as inventory. The block of flats is being refurbished with the intention of leasing it under operating leases. The change in intention will cause the flats to be reclassified to investment property. The carrying amount of the flats (lower of cost and NRV) will be transferred to investment property and then any fair value adjustments to the flats will be recorded in profit or loss. This transfer may only be made when the operating lease agreements are entered into, see IAS 40.57(d).

   The town house is also classified as inventory. A decision has now been made to hold the town house for capital appreciation (i.e. will no longer be sold as part of ordinary business activities). The town house will not be reclassified however and will remain recorded as inventories and measured at the lower of cost and net realizable value.